No. 22070

In the

United States Court of Appeals

For the Ninth Circuit

FRED W. ALKIRE AND LOIS O. ALKIRE,
Appellants,

vs.

ROBERT A. RIDDELL,
Appellee.

On Appeal from the United States District Court for the Central District of California

APPELLANTS' REPLY BRIEF

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TOPICAL INDEX

TABLE OF AUTHORITIES CITED

Cases

Statutes

Other Authorities

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INTRODUCTION

The taxpayer in his Opening Brief (page 11) threw down the gauntlet by declaring that *in every hard mineral case where capital gain has been denied based upon the recitation of the economic interest test, the facts have plainly disclosed the absence of a sale under accepted criteria.* The Government has not only failed to take up the challenge by disputing the proposition, but has failed to distinguish the cases cited by the taxpayer. The closest the Government has come in its brief to meeting the issue head-on has been to suggest that certain of the Circuit Court of Appeals cases

cited by the taxpayer have been restricted or limited to their facts by later decisions. As taxpayer points out in a subsequent portion of this brief (Part C, infra) the Government's suggestion in this regard is totally unfounded.

Moreover, nowhere in its brief does the Government even argue that the taxpayer retained a reversionary interest in the mineral deposit, or a right to reacquire an interest in the deposit, or a right to compel exploitation of the deposit, or any other incident of ownership or ''stick in the so-called bundle of rights''. [see, *White* v. *United States* (D.C. Colo. 1966) 254 F.Supp. 894, 896-897]

The Government's position in this case is summarized in its statement on page 16 of its brief that ''[i]f a taxpayer transfers operating rights solely in consideration of payments geared to extraction and dependent upon extraction, he has retained his 'economic interest' and receives the payments as depletable ordinary income.'' The balance of the Government's brief is devoted to (i) attempting to show that the cases support the stated proposition, and (ii) attempting to show that the taxpayer in this case transferred nothing more than ''operating rights'' and received no consideration other than production payments.

The Government never tells us what is meant by the term ''operating rights''. If the term means merely the right to enter upon the property for a period of time for the purpose of extracting minerals therefrom (i.e., a typical mineral lease) then there can be no quarrel with the statement, since there would be no sale or exchange of the property within the meaning of Section 1222 of the Internal Revenue Code. If, on the other hand, the phrase ''transfers operating rights'' is used in a broader sense to include those transactions having all of the generally accepted characteristics of a sale, the proposition is simply not supported by the cases and, in any event, would not be applicable to this case since the taxpayer here received other consideration wholly unrelated to the extraction of minerals.

REPLY TO ARGUMENT

A. Comments on "Introduction", Appellee's Brief Pages 8 and 9

In its effort to reshape the instant case into one which will fit into the mold established by its statement of position, the Government begins by establishing a premise which begs the question. Thus, the Government on page 8 of its brief asserts as an "undisputed" matter that the agreement to pay three cents per ton of materials extracted, produced and sold was the sole consideration to taxpayer for the transfer of taxpayer's rights under the June lease. Nothing could be further from the facts. In the first place, the record makes it clear that the "royalty" agreement was part of the consideration for the sale by taxpayer of his sand and gravel business operation, which included taxpayer's rights under the *December* lease, not the June lease. The June lease, as to taxpayer, was a mere formality; taxpayer's rights thereunder were transitory and illusory. [See Appellant's Opening Brief, Parts B and C, pages 18-23] Secondly, the record shows that the "royalty" agreement was not the *sole* consideration to taxpayer for the transfer of his sand and gravel business operation (including his rights under the December lease). In addition, the taxpayer received THREE THOUSAND DOLLARS ($3,000.00) cash for his leasehold improvements (under the December lease), and FIFTY-SEVEN THOUSAND DOLLARS ($57,000.00) cash for his machinery and equipment. [See Appellant's Opening Brief, Statement of Facts, pages 3-7]

The Government itself acknowledges the questionability of its assumed premise (that it was the taxpayer's rights under the June lease which were transferred for consideration of the "royalty") when later in its brief it concedes that there is at least some question as to which leasehold rights were transferred for consideration. [See Appellee's Brief, footnote 2, page 21]

B. Comments on "The Controlling Principles", Appellee's Brief, Pages 9-16

Having hopefully established as a premise that (i) the taxpayer transferred nothing other than his rights under the June lease, and (ii) the sole consideration for this transfer was the "royalty" agreement, the Government proceeds to cite a number of Supreme Court cases which hold that the granting of nothing more than the right to extract minerals solely for the consideration of production payments yields depletable ordinary income. The taxpayer does not dispute these holdings. Their pertinence to this case, however, depends upon the validity of the Government's premise. With the fall of the premise must also fall the relevancy of the cited decisions.

None of the cases cited by the Government deal with situations in which, under well established criteria, there was an absolute sale of the land containing a hard mineral deposit.

C. Reply to Appellee's Argument That Taxpayer Retained an "Economic Interest"

The Government states that five Courts of Appeal have held that where the taxpayer transferred "operating rights in hard minerals" solely in consideration of payments per unit, the payments are depletable ordinary income. An analysis of the facts of the cases referred to sheds light on what the Government means by "operating rights", for in every one of those cases the court specifically found that there had *not* occurred a *sale* under established criteria. In each of the cases the court determined that, aside from the right to receive production payments, the transaction lacked the essential characteristics of a sale, and constituted nothing more than a lease or a license. Such a finding is determinative of the tax treatment to be accorded the payments received, for there can never be capital gain in the absence of a sale or exchange.

The Government states that *Royalton Stone Corporation* v. *Commissioner* (2d Cir. 1967) 379 F.2d 298, involved "similar facts", and that it "directly supports" the District Court's decision in this case. In fact, the case is quite different on its facts since it did not involve a sale or anything closely resembling a sale. In this connection, the Court stated:

> "Upon close examination the incidents of the transactions into which the parties entered prove to be a licensing arrangement with provisions for royalty payments rather than a sale of the minerals. The taxpayers merely licensed the corporations to remove the minerals in return for a share of the proceeds of their sale. The only property transferred to the corporations by the agreements was the right to quarry the minerals. There was no present conveyance of anything else.
>
> "The taxpayers expressly reserved legal title until some indefinite future time and, as an appropriate incident of ownership, were obliged to pay taxes and assessments on the property. It is clear that they continued to own the minerals until they were removed truckload by truckload." [379 F.2d at 299-300]

Nowhere in the opinion did the Court purport to restrict or limit its decision in *Barker* v. *Commissioner* (2d Cir. 1957) 250 F.2d 195, as suggested by the Government; the Court merely distinguished *Barker,* along with *Crowell Land & Min. Corp.* v. *Commissioner* (5th Cir. 1957) 242 F.2d 864, and *Gowans* v. *Commissioner* (9th Cir. 1957) 246 F.2d 448, since those cases clearly involved *sales,* and *Royalton* clearly did not.

Next, the Government states that the law of the Fifth Circuit today is *Wood* v. *United States* (5th Cir. 1967) 377 F.2d 300, and that *Wood* "squarely supports the instant decision". The taxpayer does not dispute the

fact that *Wood* is good law; but *Wood* involved a "typical mineral lease" [377 F.2d at 305]. Thus, the holding of the Court was to be expected, and has no bearing on the instant case. The Government again appears to equate the distinguishing of a case on its facts with the disapproval thereof, by suggesting that the Court in *Wood* disapproved *Crowell.* The Court merely distinguished *Crowell* because *Crowell* involved a *sale,* and in so doing the Court stated the obvious—that a transaction does not become a sale rather than something else, merely because the word "sale" is used in the operative instruments. The use of words of sale is merely *one* of the indicia of a sale which, standing alone, is not determinative.

Finally, the Government suggests that the decision in *Rabiner* v. *Bacon* (8th Cir. 1967) 373 F.2d 537, limited *Commissioner* v. *Remer* (8th Cir. 1958) 260 F.2d 337, to its facts. *Rabiner* involved a "usual and simple form of mining lease" [373 F.2d at 538] and, thus, as in *Wood,* the holding was entirely predictable. Nowhere in its opinion did the Court purport to limit its decision in *Remer* to its facts; the Court merely distinguished *Remer* because *Remer* involved a *sale,* and *Rabiner* did not.

The Government also cites the Fifth Circuit's decisions in *United States* v. *Peeler* (5th Cir. 1967) 377 F.2d 531 and *United States* v. *Green* (5th Cir. 1967) 377 F.2d 550, the Seventh Circuit's decisions in *Schreiber* v. *United States* (7th Cir. 1967) 382 F.2d 553 and *Freund* v. *United States* (7th Cir. 1966) 367 F.2d 776, and the Third Circuit's decision in *Laudenslager* v. *Commissioner* (3rd Cir. 1962) 305 F.2d 686.

Peeler and *Green* were companion cases to *Wood,* and were decided by the Fifth Circuit on the same day as *Wood. Peeler* involved "a lease agreement . . . between taxpayer and Weston & Brooker whereby the latter was given the right to prospect on taxpayer's land for a period of six months. The agreement also provided that if after this period, Weston & Brooker wished to mine, the contract

could be kept in force for twenty years by the payment of a yearly minimum royalty and a specified royalty per ton of mineral removed." (The lease was subsequently extended for an indefinite period of time.) [377 F.2d at 531-532] *Green* involved a "lease contract" which was to be in effect for ten years, with an option to renew for an additional ten years. It could be terminated at any time that the lessee might decide the mineral deposits could not be profitably exploited. [377 F.2d at 550]

Schreiber involved agreements found by the Court to constitute leases.

> "The 1957 agreement was described as a 'lease' in four important respects:
>
> 1. Reserving the owners' right to use all the land for agricultural purposes until needed for use by Merget.
>
> 2. Providing a five-year term, with the three-year renewal right.
>
> 3. Granting the owners the right to terminate upon Merget's bankruptcy or insolvency.
>
> 4. Granting the owners the right to terminate in the event of any default by Merget.
>
> "In May 1963, taxpayers and Merget executed an identical agreement, except that in the second instrument 'agreement' was used throughout in substitution of 'lease'." [382 F.2d at 554]

Freund likewise involved a lease.

> "* * * But the language of the agreement is couched in the terms of a lease and its provisions contain all the indicia of a lease for a definite term for the purpose of extracting sand and gravel from the premises. Moreover, there is nothing in the record, including the answers to

the interrogatories and the deposition of the taxpayer, which indicates any contrary intention of the parties.'' [367 F.2d 778]

Laundenslager involved ''simply an arrangement whereby Brewster was granted the right to excavate and remove earth fill in return for a royalty of a specified sum per unit of material taken.'' [305 F.2d at 691]

None of the five Circuit Court decisions discussed above shed any new light on the question at hand. All of them merely reaffirm what has already been stated by this taxpayer—that in every hard mineral case where capital gain has been denied the facts have plainly disclosed *the absence of a sale* under generally accepted principles.

In sum, the Government's underlying position seems to be that in every case where the taxpayer retains a right to receive payments based upon the exploitation of the property transferred (i.e., a ''royalty'') there can be no *sale* and hence no capital gain. Not only do the authorities cited by this taxpayer in his Opening Brief show that this is not true where there has been a *sale* (under accepted principles) of mineral producing property, but this contention by the Government flies in the face of well established holdings in other contexts. For example, it is settled than an amateur inventor is entitled to capital gain treatment where he transfers his patent rights *solely* in consideration of ''royalty'' payments based upon the exploitation of the patented item.[1]

United States v. *Carruthers* (9th Cir. 1955) 219 F.2d 21

Kronner v. *United States* (Ct.Cls. 1953) 110 F.Supp. 730, 732-735

Commissioner v. *Hopkinson* (2d Cir. 1942) 126 F.2d 406, 409-410

1. This principle was established prior to the enactment of Section 1235 of the Internal Revenue Code. However, it is still the law in situations where, by its terms, Section 1235 is not applicable. See, Reg. Sec. 1.1235-1(b); *Leonard Coplan* (1957) 28 T.C. 1189, 1192.

The same principle applies where a trademark is sold in consideration of a "royalty" agreement.

Reid v. *Commissioner* (1956) 26 T.C. 622

Also, where a business is sold and the seller reserves the right to a share of the future earnings of the business, the transaction is treated as a capital transaction giving rise to capital gain or loss.

Vermont Transit Co. v. *Commissioner* (2d Cir. 1955) 218 F.2d 468[2]

The Government's position, therefore, is wholly untenable where, under accepted and well established criteria, there has occurred a *sale* of the mineral producing property.

D. Reply to Appellee's Argument That the "Royalties" Should Be Taxed As Short Term Capital Gain

After rightly and properly stating throughout the major portion of its brief that the substance of a transaction and not the legal forms employed is controlling (Appellee's Brief, page 16) and that the mere wording of agreements is not determinative of tax consequences (Appellee's Brief, page 19), the Government in the concluding portion of its brief surprisingly becomes completely absorbed by the form of the transaction before this Court, to the exclusion of its substance. The transaction is viewed by the Government in terms of a simplistic syllogism, thusly: The property which the taxpayer sold in consideration of the "royalty" agreement was his interest as a co-lessee under the June lease. Taxpayer had a holding period of less than six months for this interest. Therefore, the gain from the sale (i.e., the "royalties") was short term capital gain.

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2. It is interesting to note that in the *Vermont Transit Co.* case it was the Government, not uncharacteristically switching roles, which argued that the participation in future earnings *did not* constitute the reservation in the seller of an "economic interest" for tax purposes.

The fallacy of this syllogism lies in its major premise; for the record makes it plain that it was taxpayer's interest under the *December* lease, not the June lease, which was bargained for and sold. (See, Appellant's Opening Brief, Parts B and C, pages 18-23) Moreover, in order to make this crystal clear and beyond dispute, the taxpayer requested the special finding which was denied [CT 137-138].

Contrary to the assertion of the Government, taxpayer does *not* contend that the June lease merely continued his interest under the December lease. Taxpayer, rather, contends that it was his interest under the December lease which in substance was transferred, for which interest he clearly had a holding period of more than six months; and that the execution of the June lease by taxpayer was merely a formal step, without substance as to taxpayer, by which the transfer of his interest under the December lease was accomplished. (See, Appellant's Opening Brief, Part C, pages 20-23)

The rule that the substance of a transaction, and not its form, will govern the tax consequences is so firmly entrenched that it applies equally in favor of the taxpayer as it does for the Government. Thus, it is well settled that a taxpayer can prove that his intent was different from that expressed in his own contract.[3]

> *Peerless Steel Equipment Company* (1967)
> 26 T.C.M. 880

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3. The Government has now announced its acquiescence to the decision in *Samuel D. Miller* (1967) 48 T.C. 649 [cited in Appellants' Opening Brief at pages 19 and 22] I.R.B. 1968-4, 5.

CONCLUSION

For the reasons stated in Appellant's Opening Brief, and stated above, the decision of the District Court should be reversed.

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February ..., 1968

I certify that in connection with the preparation of this Brief, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing Brief is in full compliance with those rules.

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